**Internal Revenue Service**

# memorandum

CC:TL
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date: 29 AUG 1986

to: Deputy Regional Counsel
Southwest Region CC:SW:TL

from: Director, Tax Litigation Division CC:TL

subject: [redacted]

This memorandum responds to your request of June 16, 1986, for technical advice in the above-referenced case involving petitioner's liability for windfall profit tax. Because of the widespread impact of the Service's actions, the conclusions expressed herein have been informally coordinated with the Interpretative Division and the Legislation and Regulations Division which have expressed their concurrence.

## ISSUES

1. Whether Temp. Reg. § 150.4996-1(i), TD 7846, 1982-2 C.B. 353, effected a substantial change to Temp. Reg. § 150.4996-1(i), TD 7690, 1980-1 C.B. 259.

2. Whether, if such change was substantial, the Secretary abused his discretion in making the effective date of Temp. Reg. § 150.4996-1(i), (1982), retroactive to February 29, 1980. 7805.04-00

## CONCLUSIONS

1. The amendment to Temp. Reg. § 150.4996-1(i) effected by T.D. 7846 was substantial in nature.

2. The Secretary did not abuse his discretion by making the amendment to Temp. Reg. § 150.4996-1(i) retroactive to February 29, 1980.

## FACTS

On April 4, 1980, temporary regulations were published defining "property" for windfall profit tax (WPT) purposes as having the same meaning as that term is given under the Energy Regulations. Treas. Reg. § 150.4996-1(i), T.D. 7690, 1980-1 C.B. 259, 45 Fed. Reg. 23384, April 4, 1980. Under the Energy Regulations, a property is defined as a right to produce domestic crude oil which arises from a lease or a fee interest,

in existence on January 1, 1972. These Energy Regulations were promulgated by the Federal Energy Administration (FEA) prior to October 1, 1977, and by its successor, the Department of Energy, (DOE) thereafter. This rule is referred to as "the 1972 rule."

On November 10, 1982, in T.D. 7846, 1982-2 C.B. 353, 47 Fed. Reg. 50858, Treas. Reg. § 150.4996-1(i) was amended to provide that, for WPT purposes, the term "property" means the right to produce domestic crude oil, which arises from a lease or fee interest, on January 1, 1972, provided such right was in production in commercial quantities on that date. If the right was not in production in commercial quantities on January 1, 1972, the determination of "property" is generally to be made by reference to the geographical boundaries of the right to produce crude oil when crude oil is first produced thereafter in commercial quantities. This change as set out in the amendment to the temporary regulation is known as the "production rule." The text of the temporary regulations also served as the text of proposed regulations cross-referenced in a notice of proposed rulemaking at 1982-2 C.B. 930.

Taxpayer, a producer of crude oil, determined the tier classification of the wells it operated in accordance with the 1972 rule. The Service has determined deficiencies in accordance with the production rule.

Taxpayer asserts that the Service's replacement of the 1972 rule with the production rule is a material, substantive change and its failure to observe the notice and comment requirements of the Administrative Procedures Act (APA) renders the amendment invalid. It is also urged that even if all procedural safeguards were observed, the retroactive application of the regulation is unfair and unlawful.

## ANALYSIS

The Crude Oil Windfall Profit Tax Act (WPTA) of 1980, (I.R.C. § 4986 et seq.) imposed, effective March, 1, 1980, a tax on all production of domestic crude oil after February 29, 1980. Although called a tax on profits, the tax is a temporary excise or severance tax on production, imposed at the wellhead as each barrel of oil is removed from the ground and sold.

I.R.C. § 4987 provides that the amount of tax imposed with respect to any barrel of taxable crude oil is the applicable percentage of the windfall profit tax on that barrel. The rate of tax depends on the type or tier of oil produced from the property. In order to determine the tier of taxable oil, it is often necessary to determine the "property" from which the oil

is produced. For example, the determinations of newly discovered oil, stripper well oil, heavy oil, and incremental tertiary oil are made on a property-by-property basis.

I.R.C. § 4997(b) provides that the Secretary (of the Treasury) shall prescribe such regulations as may be necessary or appropriate to effectuate the purposes of the statute, including such changes in the application of the energy regulations that may be deemed necessary to fulfill the purposes of the statute.

I.R.C. § 7805(a) authorizes the Secretary of the Treasury (Secretary) to prescribe all needful rules and regulations for the enforcement of the Internal Revenue Code. Section 7805(b) provides that the Secretary may prescribe the extent, if any, to which any ruling or regulation shall be given prospective application only.

Treas. Reg. § 301.7805-1(a) states that the Commissioner, with the approval of the Secretary, shall prescribe all needful rules and regulations for the enforcement of the Code (except where this authority is expressly given by the Code to any person other than an officer or employee of the Treasury Department), including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue. Treas. Reg. § 301.7805-1(b) provides that the Commissioner, with the approval of the Secretary, may prescribe the extent, if any, to which any regulation or Treasury decision relating to the internal revenue laws shall be applied without retroactive effect. The regulation also provides that the Commissioner may prescribe the extent, if any, to which any ruling relating to the internal revenue laws, issued by or pursuant to authorization from him, shall be applied without retroactive effect.

The statutory language of the WPTA does not define the term "property." The reports of the House Ways and Means Committee and the Senate Finance Committee provide such a definition. The Senate Report, S. Rep. No. 96-394, 96th Cong., 1st Sess. (1979), states at page 52:

> For windfall profit tax purposes, the word "property" has two different meanings. Generally it has the same meaning as that term is given by the price control regulations. See 10 C.F.R. sec. 212.72(a); FEA Rul. 1977-1, 42 Fed. Reg. 3628 (1977). "Property", therefore, generally means either (1) a right to produce domestic crude oil which arises from a lease or fee interest, or (2) at the election of the producer, separate and distinct producing reservoirs which are

> subject to the same right to produce and which are recognized as separate and distinct reservoirs by the appropriate government regulatory authority.
>
> However, in some cases the word "property" has the meaning given to it in section 614 of the Code, which generally does not allow a producer to elect to treat separate reservoirs as separate properties.

Temp. Reg. § 150.4996-1(i) (1980), provided that except as otherwise provided in section 4988(b) (relating to the net income limitation on windfall profit tax), the term "property" has the same meaning as that term is given by the energy regulations, citing 10 C.F.R. § 212.72(a) and FEA Rul. 1977-1, 42 F.R. 3628 (1977).

Temp. Reg. § 150.4996-1(i) (1982) provides generally that the "property" is determined by reference to the geographical boundaries of the right to produce crude oil as such right existed on January 1, 1972, provided such right was in production in commercial quantities on that date. If such right was not in production in commercial quantities on January 1, 1972, the determination of property is generally made by reference to the geographical boundaries of the right to produce crude oil when crude oil is first produced thereafter in commercial quantities.

The energy regulations (10 C.F.R. § 212.72(a)) define the term "property" as the right to produce crude oil which arises from a lease or from a fee interest. A producer may treat as a separate property each separate and distinct producing reservoir subject to the same right to produce crude oil, provided that such reservoir is recognized by the appropriate governmental regulatory authority as a producing formation that is separate and distinct from, and not in communication with, any other producing formation.

The Federal Energy Administration (FEA) has issued rulings in an attempt to clarify the definition of the term property. Its first attempt was Ruling 1975-15, Definition for Purposes of Computing Base Production Control Level, 40 Fed. Reg. 40832 (Sept. 4, 1975), where the FEA emphasized the "right to produce" language in the definition, then addressed the application of the definition to unitized properties. The ruling explained that since the unit agreement signifies one right to produce crude oil arising from several leases, the unit defines the property.

The next FEA attempt at interpreting the definition of property was issued as Ruling 1977-1, Clarification to Mandatory Petroleum Price Regulations Applicable to Domestic Crude Oil, 42 Fed. Reg. 3628 (Jan. 19, 1977). In this ruling the FEA

recognized that the term property connoted the "surface acreage" or "tract" to which a producer obtained production rights through an oil or gas lease. It described the relationship between the oil and gas lease and the term property as follows:

> Inasmuch as the lease is the basic document of the oil and gas industry, there should have been no doubt that CLC [Cost of Living Council] intended by its definition of property to signify the premises described by an oil and gas lease.

42 Fed. Reg. 3632.

The next attempt soon followed as Ruling 1977-2, Further Clarifications to Mandatory Petroleum Price Regulations, 42 Fed. Reg. 4409 (Jan. 25, 1977), where it took the position that a separate and distinct producing reservoir subject to the same right to produce as other reservoirs may be designated as a separate property in accordance with section 212.72 at any time on or after September 1, 1976, so long as that designation is given prospective application only.

DOE then issued Ruling 1980-3, Clarifications to the Newly Discovered Crude Oil Ceiling Price Rule, 45 Fed. Reg. 48577 (July 21, 1980), wherein it stated that where no crude oil was produced from a separate and distinct producing reservoir subject to the same right to produce crude oil in 1978, and where such a reservoir is properly designated as a separate property either before or after December 31, 1978, the crude oil produced and sold from such a reservoir-property after June 1, 1979, is eligible to be classified as newly discovered oil. However, the designation of a separate and distinct producing reservoir as a separate property is not to be applied retroactively to recertify crude oil as "newly discovered" beyond two months or before the recognition by the appropriate governmental authorities.

None of the above rulings addressed whether property determinations are to be made by reference to the year in which production in commercial quantities occurs.

The majority of the reported judicial decisions address the term "property" as applied to unitized properties. The leading decision was issued in Grigsby v. D.O.E., 585 F.2d 1069 (Temp. Emerg. Ct. App. 1978), where the court held that a multi-lease unit constituted a "property" instead of the individual leases contained within the unit. Therein the court stated:

> Grigsby is incorrect in stating that "property" is measured solely by the fee or lease-hold interest. The focus of the

> "property" definition is upon the "right to produce," not the fee or leasehold nature of the ownership interest. If Grigsby were correct in stating that the nature of the ownership interest alone controlled the definition of "property," a mineral lessee could evade the price control and allocation programs by pooling his interest with that of neighboring lessees and gerrymandering the situs of the well among the various leaseholds.
>
> The "right to produce" arises from a combination of sources, including, but not limited to, the nature of the ownership interest, contractual extension or restriction of ownership interest, and orders of state regulatory agencies. A mineral fee owner has a "right to produce" subject to state law. A mineral leasehold owner has a "right to produce" subject to the terms of the lease and state law. The mineral leasehold owner's "right to produce" may be further circumscribed by voluntary or compulsory pooling. Although the fee or leasehold interest may be the orgin of the "right to produce," such a "right to produce" is controlled, limited, or extended by contractual agreement and state authorities.

585 F.2d, 1083

In Penzoil Co. v. D.O.E., 514 F. Supp. 516 (D. Del. 1981), the court was also faced with construction of the term property under the energy regulations and the contention of the plaintiff that the Grigsby holding is limited to units created before 1972. The court noted that plaintiff was urging a construction of section 212.72 which would look only to rights to produce as they existed in 1972 in order to define the scope of the relevant property. The court rejected plaintiff's argument -- "[t]he recognition that `rights to produce' can be created by unitization orders entered after 1972 is, of course, inconsistent with (plaintiff's) argument that Section 212.72 froze 'property' boundaries as they existed in 1972." 514 F.Supp. at 518. The Temporary Emergency Court of Appeals affirmed this holding at 680 F.2d 156(1982). Thus, in unitization cases, although a new property may be created after 1972, production of the unit as a whole as it existed in the year of measurement must be compared with the combined BPCL's of the leases comprising that unit as they existed in 1972 prior to unitization. Pennzoil Co. v. D.O.E., supra, 680 F.2d 167.

The validity of Ruling 1977-1 supra, was challenged in D.O.E. v. State of Louisiana, 690 F.2d 180 (Temp. Emer. Ct. App. 1982), insofar as it precluded treatment of state designations of reservoir-wide production units as separate properties even though more than one unit may be found within the confines of a leased tract. The Court of Appeals held that where there are several production units within a single lease, there was no reason to depart from the general proposition that the lease defined the property. 690 F.2d at 190.

In Haley v. Sohio Natural Resources, _____ F.Supp _____, (Civil No. 81-1922, D.D.C. July 26, 1983), the court noted that timing was crucial in creating a property interest by lease splitting under the energy regulations. There, plaintiff, assignee in 1975 of a farm-out agreement covering the deeper portion of a lease, sought to have the oil discovered thereafter similarly categorized as stripper oil as the grantee of a working interest in shallow rights in the same lease had so certified his oil in 1976. Plaintiff contended that the entire lease should be afforded stripper well treatment because the "property", as the term is defined by the energy regulations, was a "right to produce" crude oil and therefore covered the entire lease.

In rejecting this contention the court reasoned that the reference date for determining the parameters of properties in existence prior to the imposition of price controls was January 1, 1972. Since a right to produce crude oil from the upper levels had been assigned to another party prior to 1972, that right should be considered a separate and distinct "property" from the deeper reservoir for purposes of the regulations. Thus, in 1969 when the working interest in the upper levels was assigned, two properties were created and the post-1972 assignment of the deeper levels did not merge the rights to produce into a single owner, and, even if it had, it would not, as a post-January 1, 1972 farmout, affect the rights to produce existing on January 1,1972.

Our research has failed to locate any administrative or judicial interpretation of the regulations which engraft on the right to produce as of January 1, 1972, a requirement that crude oil be actually produced in commercial quantities and we conclude, consequently, that the 1982 amendment effected a substantial change in the definition of the term "property" as it existed under the energy (and prior Treasury) regulations.

I.R.C. § 7805(a) authorizes the Secretary of the Treasury to prescribe all needful rules and regulations for enforcement of the internal revenue code including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue. Pursuant to this general authority, the Secretary may issue regulations in three forms: proposed,

temporary, and final. These regulations may be either interpretative or legislative in nature.

The Administrative Procedure Act (APA), 5 U.S.C. § 551 et seq., generally requires an agency wishing to adopt a substantive (legislative) rule to adhere to the steps set forth in 5 U.S.C. §§ 553(b), (c) and (d). In accordance with these sections, the agency must: (1) publish a notice of proposed rulemaking in the Federal Register; (2) give interested persons an opportunity to comment on the proposed rule; (3) postpone the effective date of the rule until thirty days after publication in the Federal Register. However, 5 U.S.C. § 553(b)(A) provides that neither interpretative nor procedural rules are subject to the general notice-and-comment procedures. Although not required by the APA, Treasury generally follows the notice-and-comment rules when adopting interpretative regulations. Consequently, Treasury's "legislative regulations" -- those issued pursuant to statutory authority to implement the Code -- and "interpretative regulations" -- those advising the public of the agency's construction of the Code -- are generally first published in proposed form and are subject to the notice-and-comment process before issuance in final form.

5 U.S.C. § 553(b)(B) provides that an agency may bypass the notice-and-comment process when the agency for good cause finds (and incorporates the finding in a brief statement of reasons therefor in the rules issued) that notice and public procedure thereon are impracticable, unnecessary, or contrary to public interest. Thus, under this exception to the general rule, both legislative and interpretative regulations may be published without the notice-and-comment procedure. See Redhouse v. Commissioner, 728 F.2d 1249, 1253 (9th Cir. 1984), cert. denied, 105 S. Ct. 5066 (1984).

It is the position of the Service that temporary regulations have the same force and effect as final regulations. [redacted], O.M. 19914, I-046-85 (May 22, 1985).

I.R.C. § 7805(b) provides that the Secretary may prescribe the extent, if any, to which any ruling or regulation shall be applied without retroactive effect. Thus, the provision establishes a presumption that regulations are to be applied retroactively. See e.g., CWT Farms, Inc. v. Commissioner, 755 F.2d 790, 802 (11th Cir. 1985); Anderson, Clayton & Co. v. United States, 562 F.2d 972, 979 (5th Cir. 1977), cert. denied, 436 U.S. 944 (1978). The Secretary, however, does not have carte blanche in applying a regulation retroactively; his choice must be a rational one, supported by relevant considerations. Chock Full O'Nuts Corp. v. United States, 453 F.2d 300, 302 (2d Cir. 1971). The decision of the Secretary to make a regulation or ruling retroactive is subject to review for an abuse of discretion. Automobile Club of Michigan v. Commissioner, 353

U.S. 180, 184 (1957); Wendland v. Commissioner, 739 F.2d 580, 581 (11th Cir. 1984); Redhouse v. Commissioner, 728 F.2d 1249, 1251 (9th Cir. 1984), cert. denied, 105 S. Ct. 506 (1984). In each case, the reviewing court must determine whether under all the circumstances, retroactive application is warranted. Baker v. United States, 748 F.2d 1465, 1407 (11th Cir. 1984).

Courts have delineated three sets of circumstances where an abuse of discretion will be found in applying a ruling or regulation retroactively: (1) if it would amend long-standing regulations which acquired force of law when the underlying statute was repeatedly reenacted by Congress without change, Helvering v. R.J. Reynolds Tobacco Co., 306 U.S. 110, 116-117 (1939), and justifiably relied upon by taxpayers, CWT Farms, supra, 755 F.2d at 802; (2) if it would be unduly harsh upon, Redhouse, supra, 728 F.2d at 1252, or cause inordinate harm to, CWT Farms, supra, 755 F.2d at 802, a particular taxpayer; or (3) if it would result in inequality of treatment between two similarly situated taxpayers. Automobile Club, supra, 353 U.S. at 184; IBM Corp. v. United States, 343 F.2d 914 (Ct. Cl. 1965), cert. denied, 382 U.S. 1028 (1966). We do not believe that any of the above circumstances are presented in the instant case.1/

The regulations at issue were promulgated in order to effectuate the recent enactment of the WPTA. The issuance of temporary regulations in 1980 was intended to provide the public with immediate guidance with respect to the provisions of the statute. Subsequently, the Secretary determined that his earlier interpretation was not consistent with Congressional intent and exercised the authority granted in sections 4997(b) and 7805 to prescribe regulations including such changes in the application of the energy regulations as he deemed necessary to effectuate the income tax laws. The authority granted to the Secretary to make changes in the application of the energy regulations is an explicit recognition by Congress that the Secretary was not to be bound by interpretations of the Department of Energy (or its predecessors) in his interpretation of the statute and in fulfilling his responsibility of administering the federal income tax system. The retroactive amendment in 1982 of regulations issued in 1980 can hardly be

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1/ For a general discussion of the various theories and limitations under section 7805(b), see, Lynn and Gerson, Quasi-Estoppel and Abuse of Discretion as Applied Against the United States in Federal Tax Controversies, 19 Tax L. Rev. 487 (1964), and Comment: Limits on Retroactive Decision Making by the Internal Revenue Service: Redefining Abuse of Discretion under Section 7805(b), 23 UCLA L. Rev. 529 (1979).

said to change a long-standing regulation which acquired the force of law through the doctrine of legislative reenactment. Nor do we believe that justifiable reliance on the 1980 regulations should be found. The meaning of the term "property" under the energy regulations has been "heavily shrouded in both ambiguity and controversy" 2/.

In light of the lack of any authoritative definition of the term "property", and the delay occasioned by the magnitude of the task of preparing regulations to effectuate a new statute, taxpayer had no vested interest in a hypothetical decision in its favor prior to promulgation of final regulations. See Helvering v. Reynolds, 313 U.S. 428, 433 (1941). Rather, since previous law was unclear, the basic principle that retroactive clarification of unsettled law is necessary and involves no unfairness, is fully applicable. Davis, Administrative Law Treatise, § 7.23 at p. 115 (2d. ed. 1979). Thus, we conclude, retroactive application of the regulations did not effect a change in settled law or long-standing regulations, especially in light of the dearth of administrative or judicial interpretations of the energy regulations upon which a taxpayer could claim reliance. Anderson, Clayton, & Co. v. United States, supra, 562 F.2d 985, n. 30.

Whether retroactive application would be "unduly harsh" upon or cause "inordinate harm" to a taxpayer involves the principle of estoppel against the government by detrimental reliance of the taxpayer. See Schuster v. Commissioner, 312 F.2d 311, 317 (9th Cir. 1962). It is a generally accepted proposition that estoppel should be applied against the Government with utmost caution and restraint. See Couzens v. Commissioner, 11 B.T.A. 1040 (1928). The tendency against government estoppel is particularly strong where the official's conduct involves questions of essentially legislative significance, as where he conveys a false impression of the laws of the country, because Congress' legislative authority should not readily be subordinated to the actions of an unknowledgeable official. Accordingly, the general proposition has been that the estoppel doctrine is inapplicable to prevent the Commissioner (or Secretary) from correcting a mistake of law. See Automobile Club, supra, 353 U.S. 180.

2/ Overstreet and Wilcox, The Department of Energy Crude Oil "Property" Definition - A Controversial Concept with Critical Continuing Importance Under the Windfall Profit Tax Act, 26 Rocky Mtn. Min. L. Inst. 745, 746 (1980).

However, it is conceivable that a taxpayer might sustain such profound and unconscionable injury in reliance on the Commissioner's actions as to require, in accordance with any sense of justice and fair play, that the Commissioner not be allowed to inflict the injury. Such situations must necessarily be rare for the policy in favor of an efficient collection of the revenue outweighs the policy of the estoppel doctrine in its usual and customary context. Schuster, supra, 312 F.2d 317.

We perceive no particular detriment sustained by the taxpayer in reliance on the regulations as issued in 1980 because taxpayer did not materially change its position to conform to the 1980 regulations. The only "harm" occasioned by the retroactive application of the regulations would be liability for taxes in excess of that which taxpayer believed it would owe. This "increase in taxes" is not a circumstance that is "unduly harsh" upon or which causes "inordinate harm" to a taxpayer because taxpayer did not have a vested interest in any interpretation of the statute. Helvering v. Reynolds, supra, 313 U.S. 433.

Nor do we believe that retroactive application of the regulation would result in inequality of treatment between two similarly situated taxpayers. By adopting a requirement that the date on which production in commercial quantities controls for purposes of determining the "property", the regulations provide a bright-line test applicable to all producers of crude oil. As such, the regulation does not favor one producer over another; rather, by focusing on actual production, the regulation attempts to achieve the goal of taxing profits in excess of those deemed appropriate regardless of the date the taxpayer acquired his interest. Based on the foregoing, we perceive no unequal treatment of similarly situated taxpayers. The taxpayers who have similar interests from which production in commercial quantities began during the same taxable year are treated similarly.

## CONCLUSION

Although the 1982 amendment to Temp. Reg. § 1.4996-(1)(i) effected a material substantial change in the regulations as they existed in 1980, the Secretary did not abuse his discretion in making the amendments retroactive to February 29, 1980.

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